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C O N F I D E N T I A L SECTION 01 OF 04 BRASILIA 002149

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TREASURY FOR DAS LEE AND F.PARODI

E.O. 12958: DECL: 08/11/2015
TAGS: EFIN ECON PGOV
SUBJECT: BRAZIL - POTENTIAL ECONOMIC SCENARIOS AS THE
POLITICAL SCANDAL MOVES FORWARD

REF: A. BRASILIA 1968
¶B. BRASILIA 2082
¶C. BRASILIA 1979
¶D. BRASILIA 1874
¶E. BRASILIA 1973
¶F. BRASILIA 1631
¶G. BRASILIA 2025

Classified By: Charge d'Affaires Patrick Linehan, reason 1.4 (b)
and (d
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¶1. (C) Summary: Financial markets have, to date, largely taken in their stride the interlocking set of vote-buying and corruption scandals currently engulfing Brazil's political class (ref A). Several factors are working together to insulate the economy against the political turbulence, including the credibility of GoB macroeconomic policy, record liquidity flowing to emerging markets, Brazil's strong fiscal stance (5.1% of GDP primary surplus) and its continuing current account surplus (1.9% of GDP). We see few indications that the markets' mood is changing. Indeed, over the last two years Brazil has done much to reduce its vulnerability to shocks, both external and domestic. Nevertheless, Brazil's economy is far from invulnerable to a shift in market sentiment and could suffer should the scandals deepen or the country suffer a sharp external shock. This cable looks at several possible political outcomes and the potential consequences for the economy with respect to each. In neither of the two most likely scenarios (Lula remaining until the 2006 elections or his resignation/impeachment and replacement by Vice President Alencar) would we expect a sharp change in economic policy, reflecting the overall consensus among Brazilians in favor of orthodox economic policies. While it is clear that Brazilians are fed up with the corruption of their political class, there is little evidence that they are calling for a sharp break with the current institutional framework and its economic policies. Under no set of circumstances, however, is the microeconomic reform agenda, necessary to boost potential GDP growth, likely to be retaken until after the October 2006 elections. End Summary.

Scenario One: Weak Lula Remains until 2006 Elections
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¶2. (C) Our base case scenario is that Lula will serve out the remainder of his term, albeit in a severely weakened state. Former Chief of Staff Dirceu's decision to deny all in his recent Congressional testimony placed some distance between Lula and the main body of the scandal for a time, although more recent allegations are moving the spotlight closer to Lula (septel). Despite Lula's weakened state and his diminished reelection prospects, multiple factors should help keep him from breaking sharply with the existing, orthodox economic policy line. First, after eight years of sound economic policies under the previous Cardoso administration and three years of such measures under Lula, the majority of Brazilians, who still remember the "bad old days" of hyperinflation, support an orthodox policy line. Indicative of this is the fact that Lula and his Workers' Party (PT) had to move to center on economic policy in order to become electable, and will need to remain there if they are to have any hope of reelection. Second, Lula's closest remaining advisor, Finance Minister Palocci, has been the architect of this set of policies and analysts here believe he can be counted on to strongly resist any break with the current line. Third, Lula's principal policy success to date has been the restoration of economic stability. Few expect him to risk this achievement (and perhaps his legacy) by turning to populist solutions late in the game. Indeed, many analysts expect GDP growth to pick up in the second half of 2005, perhaps giving Lula a political boost as well.

¶3. (C) Meanwhile, Lula's political weakness and the Congress's own lack of credibility look likely to prevent passage of major microeconomic reform legislation. While this will not endanger economic growth in the short term,

over the long-run it will condemn Brazil to a lower potential growth path until such time as political forces align to allow passage of tax reform, Central Bank independence, financial sector reform and expenditure reform (i.e. loosening constitutional earmarks). As the markets already have written off the microeconomic reform agenda, we would not expect any sharp changes to their assessment at this point of Brazil risk. However, some observers worry that Lula's political weakness will make it harder for him to fight off unhelpful (from the fiscal discipline point of view) congressional initiatives, such as the annual/current effort in the Senate to increase the monthly minimum wage to Reals 384 (about US$165), instead of the Reals 300 that the GoB proposed. Another worrisome example is an amendment inserted into this year's budget directives law, which provides the broad framework for the drafting of the budget and which is still pending in Congress, that would restrict the Executive's discretion to freeze expenditures for pork-barrel projects sponsored by individual legislators (the so-called "individual amendments"). The GoB also recently approved a 23% pay raise for the military phased in over two years.

¶5. (C) The area of most uncertainty in our base case scenario is what future GoB economic policies will come out of the October 2006 presidential elections. Although Lula still remains popular, he is becoming increasingly vulnerable. Extended corruption investigations no doubt would lower Lula's poll numbers even further. Any decision by Lula not to run in 2006, combined with his PT party's degraded image, would open political space for some of the more radical elements on the left. Indeed, some polls show former Rio de Janeiro governor and erratic populist Anthony Garotinho (currently ineligible to run because of his own, unrelated scandal problems) of the PMDB picking up some of Lula's left-wing supporters in a Lula-less race. Garotinho, however, would have to win against one of several credible PSDB candidates, including Sao Paulo Mayor Jose Serra (whose poll numbers have been strengthening), Sao Paulo Governor Geraldo Alckmin or Minas Gerais Governor Aecio Neves (son of the still popular Tancredo Neves). Based upon their past records, these latter three would very likely embrace a continuation of the Cardoso/Lula orthodox policy line.

Scenario Two - VP Alencar Succession

¶6. (C) The word "impeachment" floats in the air with increasing frequency in Brasilia. While not calling for impeachment, even major news weekly Veja used the cover of its most recent edition to draw parallels to the period prior to the 1992 impeachment of President Collor on corruption charges. Should Lula resign or be impeached, Brazil has a very clear constitutional mechanism for the transfer of power to the Vice President, Jose Alencar of the Liberal Party (PL). The strength of Brazilian democratic institutions and the country's successful use of these mechanisms in the Collor case suggest the transition to a new president would occur without major difficulties.

¶7. (C) Even in these difficult circumstances, there are reasons to believe that Vice President Alencar, although an outspoken and frequent critic of Brazil's current high interest rates, would not break sharply from Lula's orthodox economic policies upon taking office. First, as is argued above, a majority of Brazilians support sound economic policies and demand such from their leadership. Given his lack of experience in economic policy, Alencar would presumably turn to wiser heads for counsel -- with the likely candidates being responsible veterans of the Cardoso economic team or perhaps even former military government FinMin Delfim Netto (who is currently propounding a plan limiting government spending). Credit Suisse/First Boston (CSFB) chief economist Nilson Teixeira put the probability of Alencar pursuing orthodox policies at 70% in a recent conversation with Econoff. Other observers, including the IMF resident representative, have echoed this assessment (without assigning probabilities). Second, as was the case after Lula's election in 2002, Alencar would receive considerable pressure from the markets to support orthodox policies and would need to act quickly upon assuming the presidency to reassure investors. Most of the Brazilian public and the Congress, likely would view Alencar as a caretaker until the next elections, limiting even further his scope of action to pursue a heterodox policy mix.

¶8. (C) Given the caretaker nature of a putative Alencar presidency, we do not believe he would have the clout necessary to push the microeconomic reform agenda through Congress. This would be no worse than under scenario one above, though, as the markets would have already discounted the chances of major reform before the 2006 elections. Given congressional disarray in this scenario, however, we do not expect the Congress effectively to advance significant policy changes. Instead, we look for Congress to erode fiscal discipline opportunistically where it can in support of

individual members' re-election campaign efforts. Unfortunately, Alencar would be in an even weaker position than Lula to resist spending pressures originating in Congress. Still, such erosion should not fatally undermine overall fiscal discipline given the healthy growth of tax revenues, the Executive Branch's discretion to sequester excessive expenditures, and Fiscal Responsibility Law (LRF) restrictions on the budget process.

Scenario Three -- Lula Survives, but Opens Floodgates

¶9. (C) This scenario, which we do not believe is likely to occur, posits that Lula, feeling threatened, decides to open the fiscal floodgates and abandon high interest rates in an attempt to shore up his congressional support base to survive politically or perhaps to stave off an impeachment effort. This would require the dismissal of the champions of these policies, Finance Minister Palocci and Central Bank President Meirelles, an event that markets would greet with sharp downturns. (As Meirelles told D/NSA Shirzad in November 2004, "if you see Palocci and me leaving the GoB -- watch out".) Brazil currently is less vulnerable to external shocks than it was in the lead-up to the 2002 crisis of confidence sparked by the likelihood of Lula's election. Nevertheless, a protracted loss of faith by the financial markets likely would be characterized by a similar set of events to those that unfolded in 2002: sharp depreciation of the Real, capital flight, GoB difficulty in rolling over domestic debt (except at increased interest rates), spiking inflation, etc. Such a financial crisis would doubtless play a big part in the 2006 election campaigns, with parties such as the PSDB campaigning for a return to orthodox economic policies.

¶10. (C) Brazil has institutional safeguards limiting a president's ability to open the spending floodgates in scenarios such as this. Foremost is the LRF, which requires that specific revenue sources be identified to fund new spending commitments. These requirements can be manipulated to a degree (e.g. by unrealistically inflating predicted revenue flows in the budget), but since this requires congressional complicity, there are limits to what extent the safeguards can be undermined. The LRF also prescribes criminal penalties for those who violate it, a fact that acts as a brake on the economic policy bureaucracy, which naturally tends to resist spending pressures.

Scenario Four) PT Splinters; A Thousand Flowers Bloom

¶11. (C) Our last scenario, the probability of which is at this time difficult to assess, contemplates a discredited Lula causing the PT to disintegrate) with the radical elements of the party joining forces with past PT refugees and other fringe elements to form a new leftist party. Figures like Senator Heloisa Helena (expelled from the PT in 2003 for voting contrary to the party line) and Carlos Lessa (President of the National Development Bank until dismissed by Lula in 2004) would likely rally to this new political entity. Freed from the shackles of Palocci-imposed economic orthodoxy, this amalgam might well embrace traditional leftist economic stances) such as imposing a moratorium on foreign debt payments, increased corporate taxes, and combatative relations with the IFIs. Should the disintegration of the PT generate market upheaval) with the accompanying adverse affects on exchange, interest, and inflation rates) public debate on these heterodox "solutions" could well begin in earnest. This is not to say that any successor government to the Lula administration would adopt such measures. As noted earlier, currently there is an extraordinary degree of societal consensus on orthodox economic policies. With the moderate Campo Majoritaria wing of the PT reining in the party,s radicals, the left side of the political spectrum in Brazil embraces more or less the same macro-economic line as the center and the right. However, should the PT splinter and radicals regain their voice, while the consensus would not disappear, it would certainly fray.

¶12. (C) Although there is some risk that a Lula downfall could ultimately lead the left to unite around a less pragmatic figure than Lula, there is little reason to suspect that this reamalgamated left would be any more successful come election time than Lula was prior to his move to the political center. This could change should the scandal become so deep as to undermine public confidence in the institutions of Brazilian democracy themselves, leading to an institutional crisis that creates space for some of the untainted politicians on the left. So far, however, while it is clear that Brazilians are fed up with the corruption of their political class, there is little evidence that they are calling for a sharp break with the current institutional framework and its economic policies.

LINEHAN